Freezing Defined Benefit Pension Plans –
The Process & Post-Freeze Issues

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Anyone who picks up a paper or magazine these days can find a story or article about a company announcing plans to freeze its pension plan.[1] This used to be a rare event that, by and large, only involved financially-strapped companies. Yet lately, profitable companies, including Verizon Communications, Inc., IBM Corporation, and Sprint Nextel Corporation, have joined the chorus of those announcing freezes to their plans.

What is going on here? It could be that U.S. companies are reacting to stiff competition overseas and at home from companies who do not sponsor defined benefit plans. It could also be that pension freezes are in response to companies' growing concern that defined benefit plans have become more costly and risky, with no relief on the horizon. In fact, Congress recently passed legislation that makes defined benefit plans more expensive by raising flat-rate employer premiums from $19 to $30 per participant for single employer plans, and from $2.60 to $8.00 per participant for multiemployer plans[2] and imposes benefit restrictions on plans that are less than 80% funded.[3] In view of these developments, it appears unlikely that the recent flood of announcements regarding pension freezes will subside any time soon.

But what, exactly, does it mean to "freeze" a pension plan and what are the legal implications for a company in doing so under the Employee Retirement Income Security

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[1] *See* Ellen E. Schultz, Charles Forelle and Theo Francis, *Forecast: More Pension Freezes*, The Wall Street Journal, Jan. 12, 2006; Pamela Yip, *Companies Warm to Freezing Pensions*, Dallas Morning News, Jan. 11, 2006, Albert B. Crenshaw and Amy Joyce, *IBM Adds its Name to List of Firms Freezing Plans*, Washington Post, Jan. 6, 2006, at A01; Nanette Byrnes, *The Rush to Shut Down Pensions*, BusinessWeek, Jan. 9, 2006.

[2] This legislative change is part of the Deficit Reduction Omnibus Reconciliation Act of 2005, Public Law No. 109-171, that was signed into law on February 8, 2006. The premium increase, which is set out in Section 7201 of the legislation, is effective as of January 1, 2006. After 2006, premium rates will increase at the rate of inflation.

[3] This legislative change is part of the Pension Protection Act of 2006, H.R. 4.

Act of 1974, as amended ("ERISA") and the Internal Revenue Code ("IRC" or "Code").[4] This article examines these and other questions below.

A. Background on Pension Freezes

With all the talk about pension freezes, there has been very little discussion about what a pension freeze means. According to the Pension Benefit Guaranty Corporation ("PBGC"), the federal agency that insures defined benefit pensions, a plan can be frozen by a sponsoring employer in one of several ways:

1. The plan is closed to new entrants while those participants already in the plan continue to accrue benefits.
2. The plan stops benefit accruals for all active participants, but allows benefits to increase with the growth in participants' wages ("soft-freeze").
3. The plan stops benefit accruals for some, but not all participants ("partial freeze").
4. The plan stops service accruals for all active participants and participants stop earning benefits. Assets remain in the plan and are paid out when workers retire or leave, but the workers benefits do not grow with additional years of service ("hard freeze").[5]

Until recently, there was little or no empirical data on pension freezes. In 2002, however, the federal government began requiring plan administrators to report "hard freezes" in the Form 5500 report that must be filed by employers each year.[6] In this regard, the Form 5500 now asks administrators to answer yes or no as to whether "as of the last day of the plan year, the plan provides that no participant will get any new benefit accrual (whether because of service or compensation)." A recent PBGC study examined Form 5500 reports that plan administrators filed for the 2003 year. The data compiled by

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[4] This Article does not address in detail the procedural requirements for freezing a pension plan, such as the requirement that a plan sponsor provide notice of a significant reduction in the rate of future benefit accruals under ERISA § 204(h) and Code § 4980F.

[5] There are varying definitions of "hard," "partial," or "soft" freeze that have been used by pension professionals that may differ from how the PBGC defines these terms. *See* PBGC, *An Analysis of Frozen Defined Benefit Plans*, Dec. 21, 2005, at 1, 5 (defining terms).

[6] ERISA § 103 and Code § 6058.

PBGC suggests that approximately 9.4% of defined benefit plans are "hard frozen," meaning that no participants are accruing any new benefits under the plan. In other words, the PBGC study indicates that nearly one in every ten defined benefit plans is a frozen plan.[7]

There are few restrictions on employers if they decide to join the growing number of companies that have frozen their plans. Both ERISA and the Code contain "anti-cutback" rules that generally prohibit a sponsoring employer from amending a plan to take away or reduce a plan's accrued benefits.[8] Even though companies are not generally permitted to make retroactive changes, with few exceptions,[9] plan sponsors are permitted to make prospective changes to the benefits that participants accrue. The simple mechanism for doing so is to have the plan's trustee or board of trustees amend the plan so that additional benefits will not accrue subsequent to a "freeze." Before the amendment takes effect, the plan administrator is required by statute to give notice to participants and other applicable persons of the freeze.[10]

Of course, this process is very different from terminating a plan. Title IV of ERISA permits a plan sponsor to terminate a fully funded plan on sixty days notice in a standard termination.[11] In that event, the employer must pay out all benefits immediately, either as a lump sum or by buying employees an annuity.[12] If the plan is underfunded,[13] the plan sponsor may terminate a plan (and thereby transfer its liabilities to PBGC) only

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[7] PBGC, *An Analysis of Frozen Defined Benefit Plans*, Dec. 21, 2005, at 1. The PBGC's study was confined to single employer plans and presumably did not cover plans that already had been terminated.

[8] Code § 411(d)(6).

[9] One such exception is where pension benefits are being paid out to workers pursuant to a collective bargaining agreement. Because pension benefits fall within the scope of the terms and conditions of employment that are subject to collective bargaining, prospective changes to workers' benefits typically must be negotiated by the bargaining parties. *See UMWA Health and Retirement Funds v. Robinson*, 455 U.S. 562, 575 n.14 (1982) (a retiree has recourse under federal labor law "for breach of contract if his benefits were unilaterally changed").

[10] ERISA § 204(h) and Code § 4980F.

[11] ERISA § 4041(b)(1)(A).

[12] ERISA § 4041(b)(3).

[13] Some underfunded pension plans are funded up to be fully funded to simplify the termination process. However, because this approach would often involve significant up-front financial burdens, freezing a pension plan is often adopted as an alternative.

by meeting certain financial distress criteria.[14] Outside of a few exceptions, it is typically only companies who are in bankruptcy who can transfer their liabilities to PBGC.[15] PBGC also has the authority to terminate a plan on its own initiative in an "involuntary" termination.[16]

B. Legal Implications

Even after a pension freeze, the legal requirements for a frozen plan vary little from those applicable prior to a freeze:

1. Funding Obligations

When plan sponsors elect to freeze a plan, they often point to the need to reduce long-term financial obligations. However, as a general matter, an employer's legal obligation to contribute to a plan will not change after a pension freeze. Both ERISA and the Code require employers to make minimum annual contributions to defined benefit plans and provide no exception for frozen plans.[17] To be certain, however, the amount of annual contributions required by minimum funding standards is determined in part by the total accrued benefit liability for which the employer is responsible.[18] In light of these standards, employers may still be required to make minimum contributions to plans after they are frozen, particularly if such plans are underfunded.

The same is true of pension premiums that are owed to PBGC. Sponsoring employers must continue to pay premiums based on the number of participants who are in the plan, regardless of whether the participants no longer accrue benefits.[19] As noted, the premium amount that an employer is required to pay for each participant has recently been increased and could continue to rise based on inflation.

As with premium requirements, reporting requirements are still in effect with frozen plans. A sponsoring employer still must report to PBGC certain circumstances and events as set forth under Title IV of ERISA and accompanying regulations.[20]

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[14] ERISA § 4041(c).

[15] ERISA § 4041(c)(2)(B)(i)-(ii)

[16] ERISA § 4042.

[17] ERISA § 302; IRC § 412.

[18] 29 C.F.R. § 4044.41-.75.

[19] ERISA § 4006(a)(3)(A).

[20] ERISA §§ 4010 and 4043; 29 C.F.R. §§ 4010 and 4043.

2. Disclosure Obligations

A frozen pension must continue to file annual Form 5500 reports until a plan is terminated. As noted earlier, the sponsoring employer must indicate on the Form 5500 as to whether the pension plan is "hard-frozen;" in other words, that no participants are accruing any new benefits under the plan. A frozen pension also remains subject to the disclosure rules applicable to ongoing plans, such as the requirement that updated summary plan descriptions and summary annual reports be provided.[21] Further, certain notices relating to the funded status of certain underfunded frozen pensions may also be required.[22]

3. Other Fiduciary Obligations

A pension freeze does not automatically reduce a plan fiduciary's ERISA duties. Although many functions relating to a frozen plan are settlor functions, such as the adoption of legally-required amendments, the plan fiduciary continues to be responsible for the administration of the frozen pension and the investment of its assets.[23]

In many cases, the fiduciary of a frozen pension plan is either the plan sponsor (*i.e.* the company) or a plan administration committee appointed by the plan sponsor or its delegate. In making fiduciary decisions, individuals serving as fiduciaries must take actions that are in the best interest of plan participants and their beneficiaries – not the financial interests of their employer. Alternatively, a plan sponsor may elect to attempt to minimize its ongoing fiduciary exposure by hiring an independent fiduciary for its frozen pension. While this approach may significantly reduce the exposure to the plan sponsor, the individual or entity appointing the independent fiduciary will still retain fiduciary responsibility as an "appointing fiduciary" for the selection and monitoring of the independent fiduciary.[24]

Regardless of the fiduciary structure adopted by the frozen pension's sponsor, the plan's fiduciaries retain a number of responsibilities after a plan is frozen, including the following:

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[21] ERISA §§ 102 and 103.

[22] ERISA § 4011; 29 C.F.R. 4011.1 et. seq.

[23] ERISA § 404.

[24] ERISA § 405(c).

- Fiduciaries must continue to monitor the prudence of the frozen pension's investments and investment policies, especially as the employee population covered under the frozen pension advances closer and closer to retirement age.
- Fiduciaries must continue to make sure the plan complies with ERISA's reporting and disclosure obligations.
- Fiduciaries must continue to be responsible for interpretation of plan documents and application of the plan's claims procedures.

4. Tax-Qualification Requirements

After a pension plan is frozen, it remains subject to the Code's tax qualification requirements.[25] These requirements have ongoing implications that will need to be considered at both the plan sponsor and fiduciary levels.

At the plan sponsor level, plan sponsors may, from time-to-time, need to amend their frozen pensions to reflect periodic changes to ERISA, the Code, and related regulations to maintain their tax-qualified status. As such, plan sponsors will need to continue monitoring legislative and regulatory developments to determine whether they have an impact on the design and/or operation of the frozen plan, and thereby necessitating a plan amendment (for example, a frozen plan would still be subject to the mandatory "IRA rollover" rules for cashouts between $1,000 and $5,000). This monitoring will be especially important if revised pension funding rules requiring plan amendments are enacted. Failure to maintain an up-to-date plan document may trigger significant adverse tax consequences for plan participants and their beneficiaries. In addition, plan sponsors likely will want to continue the process of obtaining an IRS determination regarding the tax-qualified status of their frozen pensions.[26]

At the fiduciary level, plan fiduciaries will need to continue to monitor the administration of a frozen pension to make sure it remains in compliance with the Code's requirements (e.g. distribution notice and election rules,[27] benefits rights and features nondiscrimination testing rules,[28] and top-heavy rules[29]), that plan operations are consistent with the plan's terms, and that all protected benefits, such as applicable grow-in rights (*e.g.*, reaching a certain age to be eligible for early retirement benefits), are

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[25] Code § 401(a) et. seq.

[26] Revenue Procedure 2005-66, I.R.B. 2005-37, 509.

[27] Code §§ 401(a)(11) and 417.

[28] Code § 401(a)(4) and Treasury Regulation § 1.401(a)(4)-4.

[29] Code § 416 and Treasury Regulation § 1.416-1, Q&A T-5.

protected. Plan fiduciaries also will need to be aware that when a plan is frozen only to new hires, there are significant risks that the plan will become more and more discriminatory and the plan's demographic will skew more to the highly-paid employees of a company. This concern is taking on increasing significance for pension plans that have been frozen for a number of years. Lastly, if the administration of a frozen plan has been outsourced to a third party, the third party will often require that certain decisions be approved by the plan fiduciary, such as decisions made under the plan's claims procedures.[30]

C. Other Implications

As detailed below, there are also a number of other implications of freezing a pension plan:

Cost and risk are often cited as the basis for freezing a pension plan. However, a pension freeze does not necessarily mitigate these concerns. From a cost perspective, freezing a pension plan does not reduce the plan's already-accrued obligations. Rather, a freeze only serves to reduce future costs, the magnitude of which depends on the type of freeze adopted. Benefits accrued prior to the freeze remain a plan obligation. The cost of funding-up a plan to its accrued levels is likely to be significant for several years following a pension freeze. Further, sponsors that attempt to compensate employees for the elimination of their defined benefit accruals by implementing enhanced 401(k) matching or profit sharing contributions will face additional cash needs because of the funding rules applicable to defined contribution plans. Unlike the funding rules for defined benefit plans, which currently permit the amortization of funding obligations over a period of time,[31] contributions for defined contribution plans must generally be made in full by the due date for a plan sponsor's income tax return (including extensions).[32]

A second issue to consider is the pending changes to the Financial Accounting Standards Board's FAS 87 pension plan accounting rules.[33] Under the proposed rules, a pension's sponsor would need to recognize the funded or unfunded status of the frozen plan on its balance sheet. This approach could significantly reduce the amount of shareholder equity in companies with underfunded plans. The benefit of a pension freeze is that a frozen plan's potential negative impact on a company's balance sheet is likely to

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[30] ERISA § 503.

[31] Code § 412.

[32] Code § 404(a)(6).

[33] March 31, 2006, Exposure Draft of Changes to FAS 87, 88, 106, and 132(R) (http://www.fasb.org/draft/ed_pension&postretirement_plans.pdf).

decline because all projected future benefits will already be accrued (*i.e.*, a frozen pension plan's accumulated benefit obligation (ABO) is equal to it projected benefit obligation (PBO)) and the ongoing flow of future contributions under the Code's pension plan funding rules will eventually result in more assets funding the frozen pension plan.

Third, a pension freeze may have an impact on relations between an employer and its employees to the extent that employees focus on the value of their existing pension benefits. For employees whose pensions have been frozen, their total compensation may be reduced unless their employers offer greatly enhanced 401(k) plans. The blow to employees' pay packages could hurt employers' ability to retain their employees and to recruit new hires. In fact, in a situation where a plan sponsor only institutes a limited freeze, such as freezing the pension plan to new hires, the net effect may be to have a divided workforce whose members have differing levels of benefits. This situation may be particularly acute in instances where employees, such as those covered by collective bargaining agreements, continue to accrue benefits under a pension plan. Lastly, an employer contemplating a pension freeze may face a workforce whose younger workers welcome the change and older workers resist or outright oppose it. Where, for instance, a freeze is accompanied by the introduction of a 401(k) plan, younger employees may applaud the move. By and large, younger employees probably appreciate the portability that comes with having a defined contribution plan. But for older employees, especially those approaching retirement, a pension freeze may not put them in as good a position as they would have been.

Fourth, a pension freeze does not shield a pension plan from litigation risk.[34] For example, many pension plans with cash balance designs have been frozen. Although it can be debated when a right of action regarding the alleged discriminatory nature of cash balance plans accrues, some plaintiffs have asserted that maintaining a cash balance plan is an ongoing violation. "Freezing" a cash balance pension plan may not prevent this allegation. However, a termination may definitively trigger the start of a controlling statute of limitations period.

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[34] The Pension Protection Act of 2006 and the recent Seventh Circuit decision in *Cooper v. IBM* appears to lessen this risk.

Fifth, as noted recently in the media,[35] executive pension plans[36] have not paralleled the decline of broad-based pension plans. These executive pension plans are regularly designed to supplement the benefits provided to executives under broad-based pension plans. The benefit formula under these executive pension plans is often the same as applies under employers' broad-based pension plans, except that the tax-qualified plan benefit limitations (e.g. the $220,000 (in 2006) compensation limitation and the $175,000 (in 2006) annual benefit limit) do not apply and the benefit payable under these executive pension plans is sometimes offset against broad-based pension plans. With the cessation of accrual under a frozen broad-based pension plan, a company's obligations under its executive pension plans may balloon significantly as an applicable offset no longer increases.

D. Long-Term Strategies

Once a pension plan is frozen, a plan sponsor should evaluate its long term strategies for handling its frozen pension.

1. Fully-Fund and Terminate the Plan

Many plan sponsors who elect to freeze their pension plans subsequently try to terminate their plans in a "standard termination."[37] To do this, the plan's assets must be sufficient to pay out the plan's "benefit liabilities"[38] – either in a lump sum (if permitted and elected by participants) or through the purchase of termination annuities that will pay out the benefits owed under the plan.[39] Some plan sponsors elect to "fund-up" their plans to a level necessary to complete a standard termination, thus cutting off their funding and fiduciary obligations.

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[35] *See* Ellen E. Schultz and Theo Francis, *Hidden Burden: As Workers' Pensions Wither, Those for Executives Flourish*, The Wall Street Journal, Jan. 23, 2006.

[36] For this purpose, "executive pension plans" means nonqualified pensions plans subject to Code § 409A that provide benefits in excess of those permitted under the Code's tax-qualified pension plan benefit limits.

[37] ERISA § 4041(b).

[38] This term is defined as "the benefits of employees and their beneficiaries under the plan (within the meaning of Section 401(a)(2) of the [Code]." ERISA § 4001(a)(16).

[39] 29 C.F.R. § 4041.28(a), (c).

2. Terminate the Plan in Bankruptcy

An alternative option for terminating an underfunded frozen plan is through a "distress termination."[40] Distress terminations generally require the approval of the PBGC and are usually permitted only as part of the bankruptcy process or if a "contributing sponsor" of the plan or its "controlled group" meet criteria demonstrating financial distress.[41] One significant drawback of a distress termination is that the PBGC only guarantees pension benefits up to a specified level.[42] If a terminated plan has assets in excess of the amount necessary to fund the PBGC guaranty, the excess assets will be used to provide additional benefits to participants in the plan.[43]

3. Unfreeze the Plan

A sponsor of a frozen plan might elect to unfreeze the plan. In light of the new funding and financial accounting rules described above, many sponsors may not elect to take this step. Depending on the final Financial Accounting Standards Board guidance, frozen plans, if fully funded or overfunded, may continue to be able to buoy a plan sponsor's balance sheet. For example, many cash balance plans provide interest credits based on the 30-year Treasury Bond rate of interest. However, cash balance plans' assets are often invested in asset classes that are intended to return higher levels of return. Unfreezing a cash balance plan might permit a sponsor to arbitrage the higher level of return while facing relatively lower ongoing annual obligations from its cash balance interest rates and reducing its annual out-of-pocket cash costs by using a cash balance plan earnings rather than actual cash contributions to an enhanced 401(k).

4. Dispose of the Plan to a Third Party

In the late 1990s and early 2000s, many pension plans were overfunded. During this time, a number of acquisition entities began offering to enter into transactions in

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[40] ERISA § 4041(c)(2)(B). Under either a distress or a standard termination, PBGC can not proceed "if the termination would violate the terms and conditions of an existing collective bargaining agreement." ERISA § 4041(a)(3).

[41] *Id.*

[42] ERISA § 4022. In 2006, the maximum guaranteed annual benefit is equal to an annual single life annuity of $47,659.08 beginning at age 65.

[43] ERISA § 4044. ERISA provides that "any residual assets" of a plan may be distributed to the employer if (1) all liabilities of the plan participants have been satisfied; (2) the distribution does not violate any provision of law; and (3) the plan provides for a distribution in these particular circumstances. ERISA § 4044(d).

which overfunded plans would be transitioned as part of an overall corporate transaction. A similar interest is now developing among investor groups who see the potential for long-term gains from assuming sponsorship of and managing the assets of frozen pension plans. These proposals involve a number of Code, ERISA fiduciary, and PBGC issues that have not been fully fleshed out or resolved at this time.

5. Use of Excess Assets and Reversions

Additional uses of frozen pension assets include the following:

- Funding health care obligations through Code section 420 transfers.
- Terminating the plan and transferring excess assets to a qualified replacement plan or providing enhanced benefits to participants in the frozen plan to obtain a lower reversion income tax rate.[44]

E. Conclusion

Freezing a pension plan may help to reduce a plan sponsor’s long-term cost and the volatility of a plan sponsor's financial obligations. However, once a pension plan is frozen, an employer and the frozen pension’s fiduciaries retain significant ongoing obligations and duties. Failure to comply with these obligations and duties could have significant adverse consequences to the plan sponsor, the frozen plan fiduciaries, plan participants, and their beneficiaries. As such, when considering a plan freeze, a plan sponsor should carefully analyze its long term strategies for the management and long-term disposition of the frozen plan to avoid significant liability exposure in the future.

[44] Code § 4980(d)(2) and (3).